

What's the best tax break available to Jane and John Q. Public? If they're homeowners, it's selling their house.

Homeowners already know the many [tax breaks](#) that Uncle Sam offers, most notably mortgage interest and property tax deductions. Well, he also has good tax news for home sellers: Most of them won't owe the Internal Revenue Service a single dime.

When you sell your primary residence, you can make up to \$250,000 in profit if you're a single owner, twice that if you're married, and not owe any capital gains taxes.

"Most people are not going to have a tax obligation unless their gain is huge," says Bob Trinz, a senior tax analyst at RIA, which provides tax information and software to tax professionals.

Some sellers are surprised by this break, especially if they've been in their homes for a while. That's because before May 7, 1997, the only way you could avoid paying taxes on your home-sale profit was to use the money to buy another, more-expensive house within two years. Sellers age 55 or older had one other option. They could take a once-in-a-lifetime tax exemption of up to \$125,000 in profits. And in all instances, there was tax paperwork (Form 2119) to fill out to show that you followed the rules.

But when the Taxpayer Relief Act of 1997 became law, the home-sale tax burden eased for millions of residential taxpayers. The rollover or once-in-a-lifetime options were replaced with the current per-sale exclusion amounts.

"There is some logic to this law change because most people under the prior rules didn't recognize a taxable gain because they rolled it over into another residence," says Trinz. "The change essentially makes it easier to dispose of your residence."

Still some requirements to meet

If you used pre-1997 rules for residential sales, don't worry. That doesn't disqualify you from claiming the exclusion on any residential sales now. The law change applies to all sales since it took effect.

Another bonus of the new rules: You don't have to buy another home with your sale proceeds. You can use the money to travel to Europe in style, buy an RV and drive across the country or get all those designer shoes you never could afford before.

Even better, there's no limit on the number of times you can use the home-sale exemption. In most cases, you can make tax-free profits of \$250,000 (or \$500,000 depending on your filing status) every time you sell a home.

Ah, but we are talking taxes here. You did notice that phrase "in most cases," didn't you? Before you put a "For Sale" sign in the yard, you need to make sure your house-sale situation is one of those "most cases."

First, the property you're selling must be your principal residence. That means you live in it. This tax break doesn't apply to a house or other property that you have solely for investment purposes. In those cases, the usual [capital gains rules](#) apply.

You can, however, turn a rental house into your primary residence, making the sale of it eligible for the exclusion. This is accomplished when you meet the IRS use and ownership tests: You own and live in the home for two out of the five years before the sale.

And your actual habitation of the home doesn't have to be sequential, notes Mark Luscombe, lawyer, accountant and principal tax analyst at CCH Inc., a Riverwoods, Ill.-based provider of tax law information and software. The IRS lets you aggregate your time living in the house to meet the two-year residency requirement.

"Generally, if you owned and used the home as your main home for periods totaling at least two years within five years ending on the date of these sale, you're eligible for the exclusion," says RIA's Trinz. "You look back at the last five years. Ownership and use may be at two different times. This would apply if you owned a home for five years, but didn't use it as your primary residence for that full period. For the first three years, you rented it and then moved into it as your main home for the final two before you sold it."

But you don't even have to live in the house at the date of sale. The flexibility of the use test means you could live in your house for a year, rent it for two, move back in for another year and rent it again the year before you sell. Since during those five years you owned and lived in the property for two years, you meet the use and ownership tests.

Finally, while technically there's no limit on the number of homes you can sell and reap tax-free gain, each sale must be at least two years apart. That still leaves you room to make some money on several properties. You can sell your residence this year, pocket any gain within the tax limits and buy a new residence. Two years later, you can do the same thing, again and again every two years.

There even are situations where owners of multiple properties might be able to double up on the tax-free gain.

"There might be instances where you sell your primary residence and then establish your vacation home as your primary home for a couple of years and then sell that home," says Trinz. "Empty nesters who have a large suburban home could move into a vacation home at the beach and then as they get older move to a residential facility so they can sell both the homes and not have any taxable gains."

Be careful, however, if you move into a rental property you acquired through a [like-kind exchange](#). The American Jobs Creation Act that was signed into law on Oct. 22 establishes a tougher test in these cases. If the property you convert to your principal residence is one that you earlier obtained via a property swap, in order to take advantage of the home-sale exclusion you must have acquired the property at least five years earlier.

Michael E. Kitces, director of financial planning for the Pinnacle Advisory Group in Columbia, Md., gives this example: A property is acquired by like-kind exchange in 1999, converted to personal use as a residence in 2002 and then sold in late 2004. Since the like-kind property was owned for five years, it meets the new tax code ownership-length provision. And having met the new five-year acquisition rule for a swapped property, Kitces says, the owner qualifies for the capital-gains exclusion since he lived in the property for two years after its conversion. If, however, the property had been exchanged in 2001, even if the seller had made it his

principal residence shortly after the date of the swap and thereby met the two-year use rule, he still would be not be able to exclude any profits on the sale.

In either case, though, the pesky reporting requirement remains history. When your gain doesn't exceed the limit, you don't have to file anything with the IRS.

Special rules for married couples

While a husband and wife get double the exclusion of single home sellers, couples also have some additional considerations when it comes to determining whether their sale is tax-free.

Either spouse can meet the ownership test. For example, the IRS says it's OK if you owned the home for the last two years, but you just added your new husband to the title when you got married six months ago. Since you owned the residence for the requisite time, as joint filers you have no problem meeting the ownership test even though your husband wasn't an official owner for that long.

However, both husband and wife must pass the use test; that is, each must live in the residence for two years. But the shared use doesn't have to be while you file jointly. If you and your now-husband shared the home for 1½ years before tying the knot and then six months as newlyweds, the IRS will allow you to claim the exemption. But if he didn't move in until the wedding day, you're out of tax-exclusion luck.

And while you're learning about your new spouse, make sure you find out all about his or her previous home-sale history. "The two-year eligibility rule applies to both spouses, so full home disclosure is another financial area you need to consider when getting married," says Trinz. "You need to find out what you're getting."

Under this couple requirement, if either spouse sold a home and used the exclusion within two years of the sale of any jointly-owned property, the couple can't claim the exclusion. That means if your new husband sold his townhouse a month before the wedding, then you'll have to wait two years after that property's sale date before you can dispose of your shared marital residence tax-free.

Figuring the correct exclusion amount

OK, you (and your better half if you're married) met the use and ownership tests, as well as the two-year previous-sale time limit. Now it's time to do the math to avoid writing a big check to the U.S. Treasury.

As a seller, you naturally focus on how much you got for your house. That is an important number, but not the only one you'll need when it comes to figuring whether you'll owe taxes on the sale.

It's your gain, or profit, that determines the size or lack of a tax bill. In fact, you can sell your house for \$1 million and still not owe Uncle Sam as long as the profit portion was not more than \$250,000 or \$500,000, depending on your filing status. If you can exclude all the gain, then you owe no taxes.

To arrive at your gain amount, you first must establish your basis in the home. For most people, says Trinz, this is what you paid for the residence and all capital improvements you've

made, such as adding a room or finishing a basement. Also, if you sold a residence prior to the 1997 law change and rolled the profit into the home you're now selling, you must account for that rollover amount; your basis will decrease by the amount of gain you postponed years ago.

"Then you compare that basis amount to what you get from the sale, less your commissions and other expenses," says Trinz. "When you subtract your cost basis in the residence, this will give you the amount of gain on the sale."

In most instances, sellers will find they made a nice profit, but not one large enough to trigger a tax bill. Some, however, could find their residences appreciated so much that the great sales prices they got ended up costing them at tax time. That's why it's important to accurately track [anything that could affect your home basis](#).

"In 1997 when this law first changed, there was a lot of talk about how you no longer have to keep records of home basis improvements, but the way the home prices have escalated you're probably safer in keeping those records," says Luscombe. "The improvements increase your basis, so a smaller portion of the selling price would be viewed as gain. Any overage is taxed at the [applicable long-term] capital gains rate of 15 percent or 5 percent.

"For those people, the old rule might have been better, but the new rule sort of rewards more frequent changes of homeownership."

Partial exclusion still a good deal

Even if you don't meet all the home-sale exclusion tests, your tax break might not be totally lost.

When an owner sells his house because of [special conditions](#), such as a change in health, employment or unforeseen circumstances, he's eligible for a prorated tax-free gain.

In such a case, the seller first calculates the fractional amount of time that he met the two-year use test. For example, a single homeowner is transferred to a job in another city and sells after being in his home for only a year and a half. He would have an occupancy period of 18/24 (the number months he lived in the home divided by 24, the number of months in the two-year occupancy requirement) or 0.75. By multiplying the full \$250,000 exclusion amount by 0.75, the seller would be eligible to exclude a sale gain of up to \$187,500.

Members of the military also get [special home-sale consideration](#). Because of redeployments, soldiers often find it hard to meet the residency rule and end up owing taxes when they sell. But a law change in 2003 now exempts military personnel from the two-year use requirement (for up to 10 years), letting them qualify for the full exclusion whenever they must move to fulfill service commitments.

So quit worrying about taxes when you put your house on the market. Chances are good that Uncle Sam won't be able to lay any claim to your hefty home-sale profit.

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